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Economic Mysteries in Insider Trading

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Economic Mysteries in Insider Trading[1]

"Insider trading" generally refers to the practice of corporate agents' buying or selling their corporation's securities without disclosing to the public significant information which is known to them but which has not yet affected the price of the security. Although this same issue can arise in face-to-face transactions with unlisted securities, most discussions of the subject assume trades across anonymous, organized exchanges or otherwise through brokers. Prior to 1961 this practice was not illegal anywhere in the world.

In that year the United States Securities and Exchange Commission published an opinion (Cady Roberts & Co.) suggesting for the first time that an insider with undisclosed information must either disclose the information or refrain from trading. Insider trading was there held to violate the Commission's Rule 10b-5, a very general statement making illegal any practice that "would operate as a fraud ..." in connection with the purchase or sale of a security. U.S. courts upheld the SEC's interpretation of Rule 10b-5 in the celebrated case of Texas Gulf Sulphur (1968), and the financial world has not been the same since.

Any discussion of this topic must begin with a disclaimer about matters not included, since there is much confusion between insider trading and various other kinds of traditionally illegal behavior. For example, the topic at issue does not include failures to disclose information required either by the terms of an employment contract or any other agreement. Thus advocates of insider trading are only referring to cases where the practice has been authorized and disclosed by the corporation. (Manne 1970) Insider trading, as used here, also does not include any form of common law fraud or a breach of an independent fiduciary duty, though often the underlying economic welfare issue is begged simply by assuming that insider trading is ipso facto a breach of a fiduciary duty. Normally the discussion would also preclude someone who was not an officer or other official of the issuing corporation, but recent U.S. Supreme Court holdings and SEC rules have cast some doubt on that exclusion.

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1 Discussion Paper.
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Another matter often confused with insider trading prohibitions is SEC Rule 16b. This rule requires that any profits made by an officer, director, or 10% shareholder as a result of buying and selling the company's securities witin a six month period be paid to the company. Thus stock purchased and held for more than six months is not covered by Rule 16b even though the purchase was clearly made to exploit undisclosed information. The legislative history and judicial interpretations of this provision make it clear that it was not intended as an insider trading rule as such, and it has played no significant role in the modern discussion of insider trading.

At the outset we might inquire why the SEC has been so insistent on a broad rule against insider trading while most countries of the world have shown little if any interest in the subject. In spite of intense international lobbying for such rules by the SEC, even those countries that have adopted such rules have shown almost no interest in enforcing them. It should be noted, however, that SEC enforcement powers, especially powers of extradition and discovery, may be enhanced by foreign adoption of such rules. Also any competitive advantage that foreign markets may have over U.S. markets because of costly U.S. regulations would be diminished if other countries adopt the same rules.

It is possible that the SEC's original interest in a rule against insider trading arose in part from its vigorous enforcement of the fixed commission rate structure for brokers on the New York Stock Exchange. Information, as a valuable commodity, could easily be used to make rebates to favored customers, thus upsetting the "cartel" arrangement and the rules of the New York Stock Exchange, which are subject to SEC enforcement. The ruling, therefore, served a dual purpose. It sent a clear signal that the use of "inside information" to lower costs for favored brokerage customers was forbidden, which certainly the brokerage community wanted. And at the same time it allowed the Commission to formulate a general rule against all insider trading, which alone the brokers may have resisted.

Even after fixed commission rates were abandoned in the United States in 1975, strong interests long supported by the SEC found other reasons for wanting to prevent corporate insiders from trading on undisclosed information. In spite of the SEC's professed interest in making new information equally available to all traders, market professionals, particularly investment bankers, would obviously be able to obtain new information and trade on it faster than the general public if corporate insiders were precluded. And specialists on the floor of the exchanges would also benefit from restricting informed trading by insiders, since they would be free of the requirement as market makers to buy from or sell to anyone in order to keep an orderly market. These market professionals strongly support the SEC's efforts to curtail insider trading, and it is likely that their counterparts in other countries have the same interests.

Subsequently the SEC developed another constituency with a strong interest in rules against insider trading. As successful hostile takeovers increased rapidly in the early 1980's, it became apparent that "tipping" information about proposed tender offers to the so-called "risk arbitrageurs" ("arbs") greatly facilitated takeovers. But the U.S. Supreme Court in the Chiarella case (1980) had already held that Rule 10b-5 did not cover a trader with no special relationship to the issuer (in that case a printer working on takeover documents). This rule would have protected the arbs, so the SEC promulgated a special insider trader rule, Rule 14e-3, pursuant to Congressional legislation on takeovers, to prevent risk arbitrageurs from using takeover information that was not yet public. Incumbent managers of large corporations subject to the threat of a takeover obviously had the most to gain from such a rule and had pressed vigorously for it. In fact without it their earlier success in securing Congressional adoption of an anti-takeover law (the Williams Act) would have been subverted by risk arbitrage. The SEC has been very successful in convincing the public that insider trading, already a popular bugaboo, was the chief evil of the takeover period, while in fact the major economic significance of that episode had little to do with insider trading.

Early in the public debate on insider trading the SEC and its supporters regularly stated that the individuals selling to or buying from insiders were injured because "they would not have sold if they had had the information." This clearly confuses ex ante and ex post considerations. A seller of stock would of course like more information about the future, just as he would prefer more wealth to less. But if a sale at a particular moment represents a rational portfolio decision, the fact that the buyer in the particular case, or for that matter any buyer may have more information than the seller should be a matter of complete indifference to the seller (Manne, 1966). The ex ante rule to be followed cannot be judged by the ex post results in particular situations. Happily this argument has largely disappeared from serious discussions of this topic.

Alternatively defenders of the SEC position may have been confusing another matter. They may have been assuming that if there were no insider trading, disclosure of the new information would have occurred at an earlier time so that this particular seller would have profited by the higher price. But this confounds the question of the impact of the insider's trade with that of the timing of corporate disclosures. There may be some general relation between the two, but for a specific trader to have lost anything, the delay in the announcement must have been caused by the requirements of the insider (see discussion below). And even if insider trading systematically encouraged delays in the time of disclosures, this would still only cause a shift of wealth from one group of uninformed outsiders to another. It would not have an effect ex ante on the average rate of return of outside investors. It would appear then that insider trading is a victimless crime, certainly so far as the trading partners of insiders are concerned. Yet in 1988 Congress increased criminal penalties and the civil liability of anyone trading "comtemporaneously" with an insider who had undisclosed information.

In the years since exposure of the fallacy in assuming that insider trading injured the outside trading partner the more serious economic arguments against insider trading have shifted ground. Today the SEC's principal argument, (sometimes supported and sometimes opposed by highly mathematical, often narrowly focused, and generally inconclusive econometric work. See Dennert) is that insider trading destroys investor confidence in the market and therefore reduces liquidity and investment. This argument has been repeated so frequently that it has gained a certain currency, thus perhaps making it something of a self-fulfilling prophecy. But this is not likely to be significant. We have no direct empirical measure of investor confidence in what the SEC terms the "integrity of the market," but the most relevant evidence on the subject (Benston) shows that investor participation in the stock market is exclusively a function of the recent performance of stock prices. If prices have risen, the public comes into the market, and if prices have tumbled, they depart. There is no evidence that revelations of particular "insider trading scandals" effect the public's willingness to invest.

It has also been argued that insiders would delay corporate disclosure of new information so that they could maximize their own return on new information, thus making the market less efficient informationally (Schotland). This is an empirical question on which, like most questions about insider trading, we are not apt to secure reliable data. The argument might be plausible (though certainly not determinative of the policy question) if we could assume that top executives would experience considerable delays in financing their stock transactions and that no one else would discover the information and use it while these financing arrangements were being made. It is far more likely that executives with volatile information would take their positions as quickly as possible and then speed up disclosure of the information in order to register their trading gains (Demsetz). After all, the faster they can move in and out of the stock, the higher will be the rate of return on any given investment.

But managers will have more reason than their own investment returns to speed up disclosure. All the vectors operating on managerial incentive (salary, job tenure, reputation, threats of takeovers, corporate profits, etc.) will also motivate managers to desire fast and accurate disclosure of new information about the company. Efficient stock pricing is a desirable attribute for corporations, and the stock of a company (and therefore the managers) will be worth more if the market believes that the stock is being priced accurately. Aside from a not very serious end-period problem, positive incentive forces should overwhelm any negative impact on disclosure timing, assuming that the insiders can even control it. Insider trading should have little impact on the timing of corporate announcements, but what it does have would seem to be beneficial.

A final argument against insider trading is that it will change the managers' taste for risk and cause them to take more risk than shareholders would prefer (Easterbrook). This would be so since greater variability in the company's stock price would provide more insider trading opportunities and because the riskier, higher-payoff investments would provide more opportunities for insider transactions without jeopardizing the fixed compensation of the executives. But managers are primarily compensated in the form of salary (Jensen and Murphy), and this in itself creates substantial risk averseness on their part. Thus insider trading may be just as likely to help right the risk imbalance resulting from salary compensation as it is to create one on its own.

But there are still additional arguments for allowing corporations to decide for themselves whether or not to permit insider trading by their managers, an option the SEC will not countenance even with full disclosure. Perhaps the central economic argument in favor of allowing insider trading is that such trading always pushes the price of the stock in the "correct" direction. That is, insiders' purchases will only be made when good news has developed and sales made only when there is bad news. To the extent that the insider's transaction has any effect on the share price, it will always be to push the share towards its correct equilibrium price. And the insider will only buy or sell up to that equilibrium point. Thus insider trading always contributes to the efficiency of the stock market (Manne, 1966).

This argument, like the argument that no outside trader is injured by insider trading, is generally accepted by all serious commentators today. But its significance has often been underestimated. Stock market efficiency, in the sense of prices quickly and accurately reflecting all news that could impact the value of shares, is essential to all of the stock market's major functions: the efficient allocation of capital by corporations and by outside investors, the correct compensation of managers, and the efficient operation of the market for corporate control. If there were effective enforcement of laws against insider trading, all corrections of price would have to come from individuals who received the information more slowly than insiders and who generally could not evaluate new developments as expertly. Certainly the stock market would be less efficient than it is with no insider trading.

The next substantial advantage that can be claimed for insider trading relates to its role in appropriately compensating managers. Clearly a right to exploit new information before it is impacted into a stock's price is valuable, and in a competitive market for managers the value of this "property right" will be taken into account in determining total real compensation (Carlton and Fischel). But the incentives afforded an insider by the right to trade and by straight salary may be quite different. Salary will always make managers more risk averse than will compensation that makes them residual claimants. Both bonuses and stock option plans have been adopted in an effort to deal with this problem, but neither of them can completely capture the incentive characteristics of allowing trading on new information (Manne 1966).

Insider trading, unlike a bonus, does not require an accounting calculation which is often based on numbers irrelevant to the purpose at hand and which may even relate "profits" to an inappropriate time period. The benefits from insider trading will be based on actual and correct increases in share price, a highly accurate estimate of the discounted present value of all anticipated future returns.

Stock options too have drawbacks not shared with insider trading. They may be exercised after a price run-up the option holder did not influence, and the proper number of shares to be optioned will always be difficult to establish. Stock options are as likely to be compensation for past performance as an inducement for future behavior. Furthermore the right to trade on undisclosed information makes managers holders of residual claims without the necessity of their also being subject to general market risk, as are shareholders and option holders. But perhaps the most significant feature of all these advantages for insider trading is that they are obtained without its costing the shareholders anything. The extra reward to the managers simply does not come out of the residual amount available for shareholders.

The principal argument against this use of insider trading is that it may bias managers' decisions in a wrong direction because it allows gains to be made on bad news as well as good. Buth this argument, though plausible, is probably not significant. All other managerial incentives, as we saw in connection with the discussion of disclosure timing, impel efforts to produce good news. Aside from an easily monitored end-period problem, these forces would overwhelm any tendency for insider trading to induce managers to produce bad news. Further, the amount of good news that the market can take is infinite, while the amount of bad news will be sharply restricted by natural market forces.

The last important economic issue in connection with insider trading has nothing to do with the intrinsic merits of the practice. Rather it has to do with the possibility of effectively enforcing the law. No one suggests that any particular rule against insider trading (short of a draconian halt to all trading anytime material information develops) could result in truly equal shareholder access to new information (Dooley). Some traders, particularly the professionals in the field, will always be quicker and smarter than the others. Thus insider trading laws, to the extent that they can be enforced, will in all likelihood merely shift wealth from one group, corporate managers, to another group, mostly market professionals (Carlton and Fischel). However, in this wealth transfer process the shareholders will lose the benefit of costlessly compensating their corporation's managers through this device.

There are obviously many straightforward problems with trying to police rules against insider trading. Detection will always be very difficult, and new forms of deception and subterfuge, though costly, will be invented constantly. This may in turn encourage regulators to use extreme measures of detection and enforcement, the economic and social costs of which can also be very high. It is clear today that vastly more insider trading occurs than the SEC acknowledges. Casual observation of stock prices reveals many cases where large price changes are followed some time later by news explaining the change. It is not likely that this phenomenon is always or even generally caused by the diligent research of financial analysts.

The strongest reason that rules against insider trading can never be very effective lies in the fact that inside information can be exploited without engaging in a securities transaction at all. As much money can be made by knowing when not to sell or not to buy as can be made from knowing when to buy or to sell. All that is required is that the object shares be held in the portfolio (in the case of good news) rather than sold, as would have occurred in the absence of inside information (and vice versa with bad news). The price of a security will rise just as much because of an increase in a seller's reservation price as through actual purchases in the market. And yet when a trader decides not to buy or not to sell, there has been no securities transaction, and it is doubtful that this could ever made illegal (Manne 1974). This mode of exploiting new information may in fact represent a principal method by which stock prices change. This would explain, among other things, why stock prices often change with little or no activity in the stock.

At a minimum then only partial enforcement of insider trading laws is feasible, and that can only be accomplished at very high compliance and avoidance costs. To the extent that the law is enforced, shareholders lose the opportunity to gain an important compensation device costlessly, and the pricing of corporte stocks becomes much less efficient than it would otherwise be. While no stockholder interest is injured by insider trading, effective laws against it result in a large and unjustifiable wealth transfer from corporate insiders to various market professionals.

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